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CABINET AFFAIRS STAFFING MEMORANDUM

Date: February 3, 1984 **Number:** 186672CA **Due By:** --

Subject: Testimony by David A. Stockman before the Senate Budget Committee (February 2, 1984)

	Action	FYI
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Vice President	☐	☐
State	☐	☐
Treasury	☐	☐
Defense	☐	☐
Attorney General	☐	☐
Interior	☐	☐
Agriculture	☐	☐
Commerce	☐	☐
Labor	☐	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☐	☐
Energy	☐	☐
Education	☐	☐
Counsellor	☐	☐
OMB	☐	☐
CIA	☐	☐
UN	☐	☐
USTR	☐	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☐	☐
CEQ	☐	☐
OSTP	☐	☐
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Baker	☐	☐
Deaver	☐	☐
Darman *(For WH Staffing)*	☐	☐
Jenkins	☐	☐
Mc Farlane	☐	☐
Svahn	☐	☐
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CCEA/Porter	☐	☐
CCFA/	☐	☐
CCHR/Simmons	☐	☐
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I. THE 1985 BUDGET PLAN

The President's 1985 Budget represents a modest further step on the long and difficult road to fiscal balance that lies ahead. It builds upon and extends the far-reaching progress made thus far in re-ordering national priorities and restraining the growth and size of domestic government. Major features of the 1985 Budget include:

- continuing through the end of the decade the virtual freeze on constant dollar domestic spending that has been in place since 1981;
- continuing the necessary realignment of budget priorities toward defense, national interest programs and other core purposes of government;
- preserving the economically essential individual tax rate reductions, business depreciation reforms and indexing provisions enacted in 1981, while pointing the way toward future tax code reform and base broadening;
- stabilizing the projected budget deficit over the next several years at about $180 billion, resulting in a decline in the deficit share of GNP from 6.0% in 1983 to 3.9% by 1987;
- reserving for next year the large structural reforms in major budget components that will be needed to bring spending and revenues back into alignment -- thereby preserving non-inflationary real economic growth over the longer term.

A. BUDGET TOTALS

The various components of the proposed 1985 Budget result in a stabilization of the deficit at about $180 billion over the next several years. Receipts are projected to grow by about 10% per

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year and outlays by about 8% per year -- with defense outlays growing faster than average and debt service and non-defense spending more slowly. These policies do not appreciably reduce the absolute level of the deficit from its 1983 peak. But relative to GNP the deficit falls by about one-third.

FY 1985 Proposed Budget

	1984 Est.	1985	1986	1987
o Outlays	853.2	925.5	992.1	1,068.3
o Receipts	670.1	745.1	814.9	887.8
o Deficit	-183.7	-180.4	-177.1	-180.5

Average Annual Increase, 1984-87:

o Receipts	9.8%
o Outlays	7.8%
o Defense	13.6%
o Debt Service ...	6.5%
o Non-Defense Programs	5.0%

Deficit Share of GNP:

o 1983 Actual	-6.0
o 1984 Estimate	-5.2
o 1985 Budget	-4.6
o 1986 Budget	-4.2
o 1987 Budget	-3.9

B. NON-DEFENSE APPROPRIATIONS

The 1985 discretionary spending authority request for the eleven non-DOD Appropriations bills is $170 billion. This consists of $132.7 billion in new budget authority plus $37.5 billion in obligation, administrative expense and lending limitations*.

* Excludes appropriated entitlements, mandatory spending and various pro forma budget authority amounts.

For non-DOD appropriated programs as a whole, the 1985 request represents:

- a 2% increase over 1984 enacted levels;
- a $0.6 billion or less than a 1% increase relative to the 1985 current services baseline.

Among the eleven non-DOD appropriations bills, the 1985 request proposes net increases to the current services level for 4 bills, net decreases for 5 bills and no change for 2 bills.

1985 REQUEST, NON-DOD ANNUALLY FUNDED SPENDING AUTHORITY 1/
(dollars in millions)

	Appropriations Bill	1985 Request	Compared to 1985 Current Services Amount	Compared to 1985 Current Services Percent	Compared to 1984 Enacted Amount	Compared to 1984 Enacted Percent
1)	Foreign Operations.	$17.9	+4.6	+35%	+5.1	+40%
2)	Energy & Water	15.8	+0.7	+5%	+1.5	+11%
3)	HUD/Independent ...	29.5	+0.6	+2%	+1.6	+6%
4)	Transportation	27.1	+0.2	+1%	+1.3	+5%
5)	Commerce/State/ Justice	11.3	---	---	+0.9	+9%
6)	District of Columbia	0.5	-0.1	-15%	-0.1	-17%
7)	Interior	8.1	-0.7	-8%	---	---
8)	Agriculture	13.9	-1.8	-12%	-5.0	-26%
9)	Treasury/Postal ...	8.9	-0.2	-2%	+0.2	+3%
10)	Labor-HHS	36.5	-2.7	-7%	-2.0	-5%
11)	Legislative Branch.	0.7	---	---	-0.1	-12%
	Total	170.2	+0.6	.4%	+3.5	+2%

1/ Includes obligational and low limitations as well as new budget authority. Excludes subsidized housing and related accounts and one-time 1984 special appropriations for IMF and Amtrak.

The proposed increases and decreases in 1985 spending authority -- along with continuation of roughly similar policy levels in the out-years -- result in a slight increase to the current services outlay baseline for non-DOD discretionary appropriations.

OUTLAY EFFECT OF NON-DOD DISCRETIONARY APPROPRIATIONS REQUEST

	1985	1986	1987	Total
Current Services	$153.2	156.2	160.2	469.6
FY 1985 Budget	+1.4	+1.8	+2.8	+6.0

C. ENTITLEMENTS AND OTHER MANDATORY SPENDING

Under current law, entitlements and other mandatory spending would total $396 billion in FY 1985, an 8% increase over the 1984 enacted level. Moreover, these outlays comprise 72% of the $550 billion non-DOD, non-interest outlay baseline for 1985.

Further steps toward restraint and reform are therefore imperative. The President's budget proposes limited measures at the present time -- with the clear understanding that even larger measures to reduce the automatic growth of these entitlement spending programs will be needed in the future. For 1985-87, the President's budget proposes:

- Medicare savings of $6.5 billion due to a phased increase in the Part B premium, a temporary freeze on physician fee increases and other smaller changes;
- Federal retirement program savings of $6.3 billion due to COLA delays, and modest civilian retirement system changes;
- Medicaid savings of $3.4 billion by extending the 1981 Reconciliation Act 3% matching reduction and mandatory co-payments for all services and beneficiaries;
- Subsidized housing savings of $1.2 billion (attributable to a number of small cost-saving steps)

- Nutrition program and AFDC savings of $4.3 billion principally due to error rate reduction and tighter eligibility definitions;

- Farm price support savings of $3.2 billion due to a freeze on target prices and the dairy price support level after the current paid diversion expires;

- GSL, pension benefit guarantee premium and other modest changes resulting in $2.4 billion in savings over three years.

While many of these reform measures will be strongly challenged by special interest groups, it should be noted that they result in only a 2% reduction in the current services baseline over the next three years.

PROPOSED SAVINGS IN MANDATORY AND ENTITLEMENT SPENDING PROGRAMS

	1985	1986	1987	Total
o Current Services Baseline	396.4	419.4	449.8	1,265.6
o Proposed Savings:				
o Medicare	-1.0	-2.1	-3.4	-6.5
o Medicaid	-1.1	-1.1	-1.2	-3.4
o AFDC	-0.8	-1.0	-1.1	-2.9
o Food Stamps/Child Nutrition	-0.4	-0.5	-0.5	-1.4
o Civilian & Military Retirement	-0.8	-2.4	-3.1	-6.3
o Farm Price Supports ..	+0.1	-1.8	-1.5	-3.2
o GSL	-0.2	-0.2	-0.2	-0.6
o Pension Benefit Guarantee Premiums .	-0.2	-0.2	-0.2	-0.6
o Subsidized Housing ...	-0.2	-0.4	-0.6	-1.2
o Other	-0.9	-0.4	-1.4	-2.7
o Total	-5.5	-10.1	-13.2	-28.8
o Savings as % of Baseline	1.4%	2.4%	2.9%	2.3%
o Memorandum Item: Current Services Baseline for Social Security and Other Programs not Proposed for Change	235.2	249.2	264.2	748.6

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D. DEFENSE REQUEST

The President's 1985 budget request represents a continuation of the necessary defense build-up begun on a bipartisan basis in FY 1981. Progress thus far is substantial:

- the 1984 enacted appropriations bills represent an increase of $116 billion or 82% from the inadequate 1980 level;
- real defense purchasing power has risen 41% -- reversing the deep decline that occured in the 1970s;
- major progress in boosting pay, improving retention, recruitment and training, restoring readiness levels, correcting the strategic imbalance and modernizing conventional weapons system has been made.

The 1985 request represents the level of funding needed to continue the programs and objectives ratified and supported by the Congress since FY 1981. While the proposed $47 billion budget authority increase, representing 13% real growth over the 1984 enacted level, may appear to be large in aggregate terms, the programmatic details behind it largely represents follow-on funding for efforts broadly supported by Congress in the last four budget rounds. Specifically, major components of the requested increase include:

- a $3.1 billion increase for military and civilian personnel. In 1984, Congress insisted on a 4% pay increase in lieu of the Administration proposed freeze;
- a $1.9 billion increase for the 1985 installment of major strategic systems, included B-1, the MX-small missile compromise plan, Trident II, air-launched cruise missiles and the advanced bomber. All of these systems have received strong Congressional endorsement over the past several years;

- a $14.3 billion increase for major conventional system modernizations including F-14s, -15s, -16s and -18s, the M-1 tank, Bradley fighting vehicle and AH-64 attack helicopter, Aegis ships and support ships to compliment the approved 15 carrier-battle groups, and various air- and sea-lift capabilities and tactical aircraft. Aside from some differences over the annual quantity mix, all of these systems in their current form have been repeatedly supported in congressional funding bills;
- a $1.1 billion increase for military retirement including system cost accruals as per the 1984 Congressional amendments;
- a $5.2 billion increase for basic readiness items including flying and steaming hours, training exercises and maintenance;
- a $7.6 billion increase for war stocks and peacetime operational reserves of spares and munitions;
- a $6.7 billion increase for cost of R&D, Military construction and other initiatives delayed or deferred by Congress in FY 84;
- a $6.3 billion increase for all other items ranging from routine base operations to advanced R&D.

With the possible exception of the last items, these increases represent the 1985 cost of existing Congressional policy. While strong arguments about the precise magnitude of some of these increases can be made by both proponents and opponents, these are differences mainly about timing and the pace of increase -- rather than the fundamental thrust of the defense build-up.

Indeed, this break-out of the 1985 request is consistent with the actual pattern of program deferrals, stretch-outs and minor trimmings contained in appropriations bills over the last three years. As is shown in the table below, enacted appropriations over 1982-84 have totaled 94.2% of the Administration's request. However, nearly 40% of even this modest reduction has been attributable to pay raise and retirement pay differences, inflation assumptions and other purely financing issues. Actual program reductions have averaged only $10.4 billion during the last two years.

OUTCOME OF DOD APPROPRIATIONS PROCESS, 1982-84
(Budget Authority)

	1982	1983	1984	Total
o Administrations's Request	$221.8	$257.5	$273.4	$752.7
o Pay, Inflation, Financing Changes ..	-2.9	-8.0	-5.4	-16.3
o Net Program Deferrals or Reduction	-6.6	-10.9	-9.9	-27.4
o Total Reduction	$-9.5	$-18.9	$-15.3	$-43.7
o Total Enacted as % of Request	95.7%	92.7%	94.4%	94.2%
o Program Reduction as % of Request	3.0%	4.2%	3.6%	3.6%

Thus, the 1985 DOD request will undoubtedly give rise to a contentious numbers debate for the next several weeks. But, as the details of the defense program are examined, it should become increasingly clear that the "increase" simply reflects the 1985 cost of the nation's unavoidable and necessary effort to restore its military capabilities and national security -- an enterprise that was launched on a bipartisan basis in 1981 and which has enjoyed broad Congressional support in all of its significant particulars ever since.

1985 DOD REQUEST

	1984 Enacted	1985	1986	1987
Budget Authority (B.A.)	258 1/	305	349	379
Budget Outlays	231	264	302	339
% B.A. Real Growth 2/	--	+13.0%	+9.2%	+3.5%
Outlay Savings from 1984 Request	--	-$13	-$13	-$6

1/ Assumes supplemental for 4% pay increase
2/ Budget authority with DOD weighted deflator

E. REVENUE CHANGES

The modest revenue changes proposed in the FY 1985 Budget embody four essential principles: 1) preservation of the across-the-board rate reductions, business depreciation reforms and indexing provisions of the 1981 tax act as essential for continued economic recovery; 2) strengthening and broadening of the tax base through elimination of unwarranted loopholes and obsolete provisions; 3) support for important economic and social policy objectives through tax incentives rather than direct spending; and 4) preservation to the largest extent possible of the net tax reduction enacted since 1981.

As is shown in the table below, proposed revenue increasing measures total $41.4 billion over 1985 - 1987. Three-fourths of this increase is accounted for by the proposed health insurance cap, tax-exempt leasing restrictions and increased federal employee pension contributions. The remainder consists of revised provisions regarding IDBs, tax shelters, accounting methods, life insurance taxation and corporate tax abuses.

The 1985 - 1987 revenue loss attributable to proposed tax incentives totals $7.9 billion, with $2.1 billion attributable to broadened IRA eligibility and other women's initiatives, and $2.2 billion to tuition tax credits and the higher education savings account proposal. Overall, the net receipt change is $7.8 billion in FY 1985 and $33.5 billion over the 3-year period.

REVENUE PROPOSALS IN 1985 BUDGET

	1985	1986	1987	Total
Current Services	737.3	803.4	873.7	2,414.4
Revenue Increases:				
o Health Insurance Cap	3.9	6.5	8.0	18.3
o Employee Pension Contributions	0.7	1.4	1.5	3.6
o State & Local Leasing	1.7	2.7	4.0	8.4
o Other Loopholes/Reforms ..	2.6	3.9	4.6	11.1
o Subtotal	8.9	14.4	18.0	41.4
Tax Incentives:				
o Broadened IRA & Other	-0.3	-0.9	-0.9	-2.1
o Tuition Tax Credit & Higher Education Deduction	-0.4	-0.7	-1.1	-2.2
o Enterprise Zones	-0.1	-0.4	-0.8	-1.3
o Extension of Jobs Credit, R&D Incentives and Other	-0.3	-0.8	-1.1	-2.2
o Subtotal, Tax Incentives .	-1.0	-2.9	-3.9	-7.9
Total Change				
o Net Revenue Increase	7.8	11.6	14.1	33.5
o % of Baseline	1.1%	1.4%	1.6%	1.4%

The modest revenue increases proposed in the FY 1985 Budget are consistent with the President's objective of preserving to the maximum extent feasible the net tax cut enacted since 1981. As shown below, the net tax reduction for 1985 will be $106 billion rising to $159 billion by 1987. For the 1982 - 1989 period as a whole, the net tax reduction due to policy changes since 1981 will total $972 billion.

NET TAX REDUCTION SINCE 1981
(dollars in billions)

	1985	1986	1987	Total 1982-89
1) Economic Recovery Tax Act (1981)	-165.0	-207.7	-248.5	-1,488.1
2) TEFRA -- 1982	+39.7	+49.3	+60.7	+327.0
3) Surface Transportation Tax Act -- 1982	+4.2	+4.4	+4.5	+28.0
4) Bipartisan Social Security & Railroad Solvency Bills	+9.5	+10.4	+12.5	+95.6
5) Other	-2.4	-2.1	-1.7	-12.6
6) FY 1985 Budget Proposals	7.8	11.6	14.1	78.5
7) Net Tax Reduction ..	-106.0	-134.2	-158.5	-971.6
Memo Item: Net Tax Reduction as Share of GNP	2.7%	3.2%	3.5%	3.0%
Memo Item: Impact of 1977 Social Security Tax Increase	+38.5	+44.2	+47.4	+310.5

II. DOMESTIC SPENDING RESTRAINT: ACHIEVED AND PROPOSED

The remaining budget deficit is large and defines an imposing task for future structural reform. However, it should not be concluded that the unprecedented and determined bipartisan measures to restrain runaway spending growth enacted since 1981 have not had a major impact. In fact, four major trends dramatize the magnitude of progress thus far and the further opportunities for restraint over the remainder of the 1980s;

1) Domestic spending will be $70 billion lower in 1985 and $318 billion lower over 1982-86 than would have been the case under pre-1981 law and policy:

DOMESTIC PROGRAM SAVINGS
ENACTED THUS FAR, 1982 - 1986

Year	Pre-1981 Baseline* (billions)	Savings Enacted (billions)	Percent Reduction	Savings as % of GNP
1982	489	-36	7.4	1.2
1983	547	-60	11.0	1.9
1984	565	-66	11.7	1.9
1985	602	-70	11.6	1.8
1986	641	-86	13.4	2.0
Total	2,844	-318	11.2	1.7

* All pre-1981 baseline entitlements and mandatory spending represents prior law as of January 1981, adjusted for actual and forecast economic assumptions over 1982-86. Discretionary spending equals the recommended amounts for 1982-1986 in the outgoing Carter Administration FY 1982 Budget. 1985 and 1986 savings are based on FY 1985 current services estimates. Figures include off-budget outlays. "Domestic programs" do not include DOD-military, net interest or $27 to $37 billion per year in national interest program expenditures for space, international affairs, DOE weapons program and related items as detailed beginning on page 3 of the FY 1985 Budget.

2) Constant dollar domestic spending will be $4 billion lower in the Congressionally enacted 1984 budget than in 1981. Under the President's proposed FY 1985 Budget, constant dollar domestic spending will remain frozen in the $520 to $530 range through the remainder of the decade. Even under current services (no further savings) it will rise only 7% between 1984 and 1989. This prospect of a decade-long freeze in real terms contrasts dramatically with the 27 years between 1954 and 1981, when real domestic spending increased nine-fold:

TREND IN CONSTANT DOLLAR DOMESTIC SPENDING
(billions of constant 1985 dollars)

Pre-1982	Amount
1954	$58
1961	126
1971	270
1981	527
Since 1982	
1984 Enacted	523
1985 Proposed	523
1989 Proposed	529
1989 Current Services .	558
Average Annual Real Growth	
1954-1981	8.5%
1981-1984 Enacted	-0.2%
1981-1989 Proposed	0.1%
1981-1989 Current Services	0.7%

3) The economic burden of the domestic budget has begun an historically unprecedented decline. After rising from 4% to 15% of GNP between 1954 and 1981, domestic spending in the 1984 budget will decline to 14% of GNP. With the additional restraint proposed in the 1985 budget, it will decline to 11.6% by 1989. Even under current services baseline projections, domestic spending will fall to 12.3% of GNP by the end of the decade -- nearly a one-fifth reduction in the economic burden of the domestic budget relative to 1981 peak levels:

DOMESTIC SPENDING AS A PERCENT OF GNP

Pre-1982	% of GNP
1954	4.0%
1961	7.3%
1971	10.5%
1981	15.0%
Since 1982	
1984 enacted	14.0%
1985 budget	13.4%
1989 budget	11.6%
1989 current services .	12.3%

4) Policies are now in place which will restrain all major components of the domestic budget compared to the unsustainable trends of prior decades:

- current services social insurance costs will grow at 2.3% per year in real terms between 1983 and 1989 compared to 8.8% between 1954 and 1983;

- current services low-income benefit programs will stabilize at $65-72 billion per year in constant dollars from 1981 through 1989 -- compared to constant dollar growth from $21 billion to $68 billion between 1970 and 1981;

- other domestic spending will have declined from its constant dollar peak of $208 billion in 1978 to $158 billion in the enacted 1984 budget -- a drop of 24%. Further contraction will occur under current services through the remainder of the decade.

Thus, the **first** step toward long-run fiscal stability has been achieved: domestic spending has been reduced substantially compared to prior policy; unsustainable real growth has been brought to an abrupt halt; and the domestic spending claim on GNP is finally heading down. The next steps must be focused on structural reform: the actual elimination, consolidation or reduction of existing spending commitments with a view to closing the budget gap at an affordable, justifiable and sustainable share of the goods and services produced by the American people each year.

III. EIGHT POSSIBLE AREAS FOR FUTURE STRUCTURAL REFORM AND MAJOR BUDGET SAVINGS

While major strides in budget control have been achieved over the past three years, it should not be concluded that all savings possibilities have been exhausted. Some programs such as agricultural price supports and student aid have escaped the general regime of fiscal restraint since 1981 and must now be firmly curtailed. Consideration of other major reform candidates -- such as military and civilian retirement -- has been deferred, but these programs must be subjected to fundamental scrutiny and revision next year. Finally, the Grace Commission report contains literally hundreds of suggestions in the areas of federal overhead reduction, procurement reform, and unjustified economic subsidies which, after further analysis and refinement, can be expected to generate substantial savings proposals for next year's budget.

In particular, the following eight budget categories illustrate the opportunities for significant future savings beyond the limited measures proposed in the 1985 budget. In most cases, the detailed analysis necessary to estimate savings and justify proposed policy changes is still underway -- with much work yet to be done. Nevertheless, they illustrate both the major opportunities as well as the kind of hard choices which will face the Administration and Congress next year in what must be a full-throttle effort to close the budget gap, if economic recovery is to be sustained.

1) Farm Price Supports

As is shown below, the 1981 farm bill will result in the highest constant dollar net outlays of any 5-year period in recent history. Fortunately, this counter-productive law expires beginning with the 1986 crop year. This presents an opportunity for major savings beginning in FY 1987 if a more market-oriented price support and subsidy program can be fashioned next year. The current wide gap between out-of-pocket production costs and price support and target levels must be substantially closed if costly surpluses and major commodity market imbalances are to be avoided in the second half of the decade:

POTENTIAL FOR FARM PRICE SUPPORT AND SUBSIDY SAVINGS: CONSTANT DOLLAR COSTS OF 1981 FARM BILL COMPARED TO PRIOR PERIODS

	Average Annual Constant Dollar Outlays	% of 1981 Farm Bill (1982-86)
1962-1966	$9.4	76%
1967-1971	10.0	81%
1972-1976	4.9	40%
1977-1981	6.1	50%
1962-1981 Average ...	7.6	62%
1981 Farm Bill, 1982-86	12.3	100%

2) Student Aid and Higher Education

Between 1970 and 1978, constant dollar federal support for student aid and higher education increased from $3.6 billion to $5.5 billion or about 53%. This substantial rise in real spending levels was generally consistent with the 80% constant dollar increase in overall domestic spending, excluding social insurance and low-income entitlements, which occured during this same period.

Since 1978, however, constant dollar spending for non-entitlement domestic spending has declined markedly as shown in the table below. By contrast, 1984 enacted student aid and higher education constant dollar outlays will be 46% higher than 1978 and only slightly below peak levels reached in 1981 ($8.3 billion). Thus, this category of the budget has escaped the general retrenchment of non-entitlement spending almost entirely. Since federal support of nearly 50% of all students enrolled in instutitions of higher education is more than the Nation can afford, a substantial funding rollback will be an unavoidable imperative on the structural reform agenda for future budgets:

CONSTANT DOLLAR STUDENT AID AND HIGHER EDUCATION FUNDING TRENDS VS OTHER DOMESTIC SPENDING
(billions of constant 1985 $)

Year	Domestic Spending Excluding Social Insurance and Low-Income Benefits*	Student Aid and Higher Education
1970	$115.4	3.6
1978	207.7	5.5
% Change from 1970.	+80%	+53%
1984 Enacted	158.4	8.1
% Change from 1978.	-24%	+46%

* As detailed in Part III, FY 1985 Budget.

3) Veterans Health Care System Efficiencies and Improvements

The operating and construction costs of the nation's veterans health care system nearly doubled in real terms between 1970 and 1980. Moreover, unlike most other categories of discretionary spending, constant dollar costs have continued to rise -- with the 1984 enacted budget up a further 8% in real terms from the 1980 level. Under the 1985 budget proposals, projected future costs continue to increase in real terms, rising by 30% between 1980 and 1989.

This rising cost trend represents both increases in medical care costs generally and the increasing pressures brought on the existing, inadequate VA system by a rising number of eligible veterans. Within the framework of current eligibility criteria, delivery system organization and hospital capacity, it is extremely doubtful that this continued rise in real budget costs can be avoided. However, the Grace Commission findings, as well as those by many medical economists, suggest that the nation's health care commitments to its veterans can be met at substantially less cost over the longer run if the current policy framework is adjusted. Such structural reform options include greater internal economic incentives, wider use of excess facilities in the private health care system, tighter implementation of the "inability to defray" standard, firmer service-connected disability requirements, and cost-sharing and third party

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cost recovery mechanisms. The Administration will be studying these options intensively within the coming years, with a view to finding ways to meet existing veterans health care commitments at significantly lower costs in the years ahead:

CONSTANT DOLLAR TREND IN VA HEALTH CARE SYSTEM

Year	Constant Dollar Budget
1970	$4.7
1980	8.7
Percent Change from 1970	85%
1984 enacted	9.4
1987 proposed	10.6
1989 proposed	11.3
Percent Change from 1980:	
1984	+8%
1987	+21%
1989	+30%

4) Medical Entitlements

The rapid, sustained constant dollar growth of the medicare and medicaid programs are nearly unprecedented in federal budget history. Between 1968 and 1981, the constant dollar cost of these entitlements rose from $17.8 billion to $65.8 billion -- or at a compound annual rate of 10.4%. Despite a variety of cost-saving reforms adopted since 1981, 1984 constant dollar spending will be up another $17 billion reflecting a 7.9% rate of annual increase. By contrast, overall domestic spending has actually declined in real terms during the same period.

Moreover, even assuming the tight reimbursement restraints embodied in the prospective payment system for medicare (DRG) and similar state level medicaid reforms, constant dollar current services costs are projected to rise another $36 billion by 1989 -- representing a 7.5% rate of annual real increase from the 1984 level.

These trends make clear that much more must be done to restrain the cost growth of the federal medical entitlements. Without such additional efforts there is virtually no prospect of maintaining medicare solvency in the 1990s, nor of meeting the rising needs of the low-income elderly and families assisted by medicaid.

Since the underlying source of this enormous, sustained cost growth lies in the structural inadequacies and inefficiencies of the U.S. health care system and the lack of economic incentives for providers and beneficiaries alike, only generic reforms of a fundamental and far-reaching nature offer the potential for significant long-term cost reduction. Such generic reforms in the areas of reimbursement, health care delivery system organization, provider risk absorbtion and beneficiary cost-sharing are therefore essential items for future consideration.

CONSTANT DOLLAR TREND FOR MEDICARE/MEDICAID
(billions of constant 1985 $)

Year	Constant Dollar Budget Level
o 1968	$17.8
o 1981	65.8
o Annual real growth from 1968	10.4%
o 1984 enacted	$82.7
o Annual real growth from 1981	7.9%
o 1989 current services .	$118.8
o Annual real growth from 1984	7.5%

5) Federal Military and Civilian Retirement Pensions

Federal civilian and military retirement pensions have historically been more generous than their private sector counterparts for reasons that have now been largely surpassed by events and policy changes over recent years. It was argued that low military pay levels prior to 1974 justified large pensions and generous early retirement privileges as a form of "deferred compensation." Likewise, until the 1983 Social Security Act, federal civilian pensions served the dual prupose of providing both a basic social insurance equivalent as well as a private pension supplement.

Nevertheless, even on the basis of these often tenuous justifications, military and civilian pension benefits have skyrocketed since the late 1960s. Whether measured in terms of cost of payroll or replacement of prior earnings, they vastly exceed real retirement annuity levels available in any sector of private employment. For instance, the normalized cost of current civilian annuities is estimated at 36% of payroll, compared to a 22% cost average for combined social security and private pensions in the private sector.

These excessive pension levels have had an enormous adverse impact on the federal budget. As shown below, constant dollar budget costs rose from $6.5 billion in 1962 to $38.5 billion in 1981 -- an average annual growth rate of 9.8% per

year. Constant dollar pension costs have increased another 6% since 1981, and current services real costs are projected to rise an additional 12% by 1989. Stated differently, by 1989 current services federal pension costs alone will exceed 1% of GNP.

These trends make clear that the fiscal burden of federal retirement pensions must be reduced substantially in the future. With both military pay at competitive rates and new federal civilian employee coverage under social security, next year's budget will present a long-overdue opportunity to constrain the cost of existing annuities, and prospectively bring federal pension benefits in better alignment with those available to private employees throughout the U.S. economy.

TRENDS IN CONSTANT DOLLAR FEDERAL MILITARY AND CIVILIAN PENSION COSTS
(billions of constant 1985 $)

Year	Constant Dollar Budget Level
1962	$6.5
1981	38.5
Average compound annual growth rate	9.6%
1984	40.8
1989 current services	45.7

6) Federal Civilian Employment

In 1985 the 2.1 million federal civilian payroll will cost $61 billion for basic compensation, health benefits, unemployment insurance and disability benefits. While considerable progress has been made in reducing excessive staffing levels in many agencies, total civilian employment remains near its 1981 level.

The detailed analysis offered by the Grace Commission of both government-wide personnel policies and individual agency staffing patterns strongly supports the presumption that major costs savings in this area are feasible. The more promising options include more aggressive contracting out through A-76 procedures; reduced staff layering and overlap between operating bureaus and departmental levels; reduction of excessive sick leave, vacation and annual leave entitlements which would permit equal work to be done with fewer FTE's; and more appropriate job classification procedures and pay comparability methodologies.

Due to the size of the federal work-force and the high rate of attrition it would not take draconian staffing reduction to generate significant savings over a reasonable period of time. On a fully implemented basis, a 5% reduction in the federal work force by 1988 would yield savings of $3.7 billion per year.

1985 COST* OF FEDERAL CIVILIAN WORK FORCE

(in billions of dollars)

Basic compensation	56.6
Health benefits	3.4
Unemployment insurance ...	0.2
FECA	0.8
Total	61.0

7) Improved Federal Procurement

Federal procurement costs in 1985 are projected to be $207 billion -- an 88% increase from the 1980 level. While the unique nature of many federal procurements -- particularly in the defense area -- makes cost comparisons with private sector practices difficult, there is little doubt among informed analysts that major cost reductions are possible with changes in existing policies and methods. Over the past three years, the Administration has launched sweeping efforts to simplify and consolidate federal procurement regulations -- and these efforts are beginning to produce tangible results.

Nevertheless, large savings depend upon basic policy changes -- most of which must be approved or supported by the relevant congressional committees. These include more extensive use of multi-year contracting, increasing the share of procurements subject to competitive bid, minimizing the

* Excludes pension costs and indirect costs (e.g. office space).

impact of social policy restrictions on the procurement process, increasing accountability within procurement management organizations, simplification of product specifications for commercial type products and greater emphasis on economically optimum quantities in procurement orders.

While many initiatives in these areas have been proposed by the Administration, particularly by DOD, they have been consistently thwarted by restrictions and outright prohibitions in appropriations and authorization bills. Given both the gravity of the budget situation and the extensive list of procurement reforms proposed by the Grace Commission, a renewed major procurement reform effort in future budgets is both warranted and a promising opportunity for significant cost reductions.

8) Special Interest Economic Subsidies

Despite major progress in eliminating or reducing special interest economic subsidies over the past three budget rounds, substantial opportunities for savings still exist. The major obstacles are the natural, parochial political pressures to retain previously granted advantages, and the more compelling argument advanced by individual interest groups that subsidies should be eliminated across-the-board or not at all.

Fashioning a consistent set of federal policy standards against which to assess local, regional and industrial sector subsidies would be a difficult and demanding task. Yet an even-handed set of criteria fairly applied could produce billions in annual budget savings. A policy framework based on user fee principles and national vs. purely local or sectoral economic benefits could be expected to reduce outlays significantly in the following illustrative areas. Most of these have been previously proposed by the Administration, but not in the context of a comprehensive policy framework:

- capital and maintenance costs for inland waterways;
- operating costs of the FAA air traffic control system;
- search and rescue, inspection and licensing costs of the Coast Guard;
- capital and maintenance costs of deep ports;
- debt repayment and interest charges on outstanding federal loans to the federal power marketing administrations;
- large interest subsidies to rural electric and telephone cooperatives;
- operating subsidies for local mass transit systems and maritime operators;
- subsidized insurance premiums offered by the Pension Benefit Guarantee Corporation and many other federal insurance agencies;

- inadequate user fees for a variety of federal commercial inspection, liscensing and information services offered by USDA, Commerce, HUD, Treasury and many of the regulatory agencies;
- charges and fees for use of federal lands, parks and other facilities;
- subsidies for local economic development which merely shift the geographic location of investment and development such as those offered by EDA, HUD, Farmer's Home Administration, Corps of Engineers, and through such tax code features as industrial development bonds.

This partial list of remaining unwarranted economic subsides provides ample evidence that potential savings of billions per year are possible if an acceptable policy framework for subsidy phase-out can be developed, and intense special interest pressures overcome. To be sure, many of these proposals have been repeatedly rejected by individual congressional committees. Nevertheless, the overriding requirement for structural budget reform to bring future spending and revenues into alignment at an acceptable share of GNP necessitates that a comprehensive program to root out unjustified economic subsidies be considered in the next budget round.

IV. DEFICIT DOWN PAYMENTS

Neither the spending control gains achieved thus far nor the wide range of opportunities for future structural reform are sufficient responses to the economic threat posed by the Federal deficit. Determined action is needed now to reduce the enormous gap between spending and revenues projected for FY 1985 and the years beyond.

Considerations of realism and practicality, however, suggest that actual implementation of modest measures to reduce the deficit now is the only viable course of action. It is virtually certain that protracted debate over sweeping measures to close the entire gap will result in no tangible action at all. Neither a workable political consensus nor an action-forcing crisis currently exists that would make grand solutions achievable during the limited time available in this session of Congress.

For these reasons the President has proposed a good faith negotiations process aimed at a down payment on deficit reduction. The 3-year, $100 billion target represents an estimate of what can be achieved on an expedited timetable based on a consensus menu of tax loophole and spending control measures that have already been extensively examined and generally endorsed by both branches, both Houses and both parties.

To be sure, achieving agreement on even these limited measures will not be easy or automatic. Compromise and flexibility by all parties to the process will be essential. In this spirit the Administration has indicated that all issues are on the table -- domestic spending, defense spending and revenue increases.

But the key to a successful outcome will be a disciplined focus on the less contentious items. There is no basis, for example, for an agreement on a complete long-term medicare solvency plan; but a variety of provider-oriented cost saving measures are included in both House and Senate Reconciliation bills and should be enacted. A new farm bill cannot be fashioned in the next month or two, but a freeze on target prices in return for adjustments in the 1984 commodity programs is a practical possibility.

Likewise, there is a basic division over the generic question of tax and benefit indexing, but COLA delays for civilian and military retirees and veterans comparable to the already enacted Social Security delay have already been endorsed by both Houses. Similarly, tax loophole closing measures such as restricting tax-exempt leasing or abusive shelters would produce desirable public policy improvements as well as additional revenues. But they avoid the re-opening of tax issues that have been already settled (such as the third-year rate reduction) or major new tax proposals that would be unacceptable to the American people.

In the defense area, the current Congressional target of $289 billion in budget authority for 1985 equals 95% of the Administration's $305 billion request. This 5% gap represents the same set of marginal differences of the pace and funding mix of the defense build-up that has taken an entire legislative cycle to resolve in each of the last two years. The President has indicated a willingness to reach an agreement in this range that is consistent with national security requirements and early, timely action on defense authorizations and appropriations bills for 1985.

In sum, the $100 billion down-payment objective is both doable and essential. Without it, there exists a serious risk that the deficit will continue to rise beyond the current $180 billion level, exacerbating the threat to continued economic recovery and compounding the problem of reaching an overall solution next year.

With such a down-payment, the deficit level can be contained and possibly be reduced. To be sure, the down payment approach will not make the issue disappear, nor make the hard choices down the road any easier. But it would provide a clear signal to financial markets at home and abroad, and to the American people that the problem is solvable and that the Federal Government can and will act to responsibly manage the financial affairs of the nation.